

We are pleased to provide our economic and market review for the fourth quarter of 2011.

Economic Overview

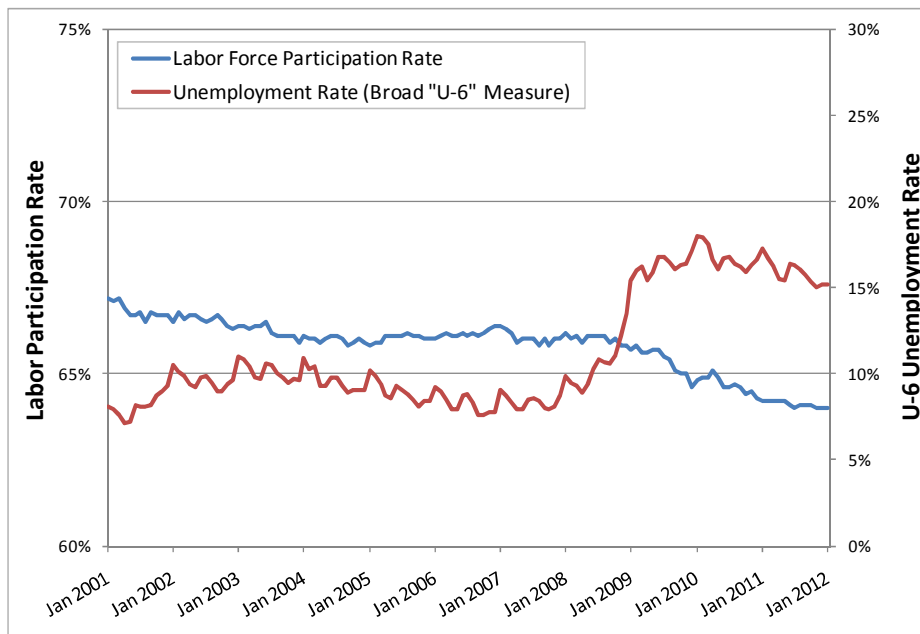
Whew, what a year! 2011 was volatile in every respect. For a four month period – August through November – markets gyrated with a magnitude not seen since the tail end of the 2007-2009 economic and financial meltdown. There was plenty going on in the real world to feed volatility in the financial world – Japan’s massive earthquake in the spring, political uprisings in Egypt, Libya and other Arab countries, the US Congress flirting with Treasury default in the process of raising the national debt ceiling in August, followed by a downgrade of US Treasury securities from AAA to AA, and of course the festering sovereign debt crisis that grips most of Europe.

KEY POINTS:

- 2011 saw elevated volatility in all asset classes, with only mediocre economic news.
- “Debt” is the theme for global asset markets in the coming year – just about everyone has too much of it.
- US stocks were flat for the year, while international stocks fell, bonds rose, and the US dollar appreciated relative to other currencies.

On balance, 2011 did not bring much positive economic news. Europe finds itself in a vicious circle. Governments there have borrowed too much, so to restore credibility while maintaining the common euro currency, they have adopted austerity budgets. The theory is that by spending less, their budget deficits will shrink and consequently they won’t need to borrow as much in the future. Unfortunately,

austerity measures have contributed to economic slowing, reducing tax revenues and frustrating efforts to shrink deficits. Europe now appears to be entering recession at a most inopportune time. Emerging markets, too, showed signs of slowing last year, as higher food costs and anti-inflationary monetary policies both applied a braking effect.



In the latter half of the year, various economic indicators suggested that

the US economy was gradually gaining some momentum after one of the deepest and longest recessions on record. Whether the US can avoid re-entering recession in 2012, however, remains hotly debated. While the unemployment rate has recently come off its post-recession highs a bit, the labor force participation rate (the percentage of all working age persons employed or actively seeking employment) remains mired at its lowest level in decades. Europe is America’s largest trading partner, so weakness over there will be a drag on growth over here. US multinationals similarly will suffer as a result of slowdowns

in their foreign markets. Finally, should European financial institutions enter a full-fledged crisis, the opaque and intertwined nature of the world financial system makes it impossible to rule out its spread into the US financial and economic system.

The US has a debt crisis of its own brewing. Budget deficits now routinely run in excess of \$1 trillion annually, meaning that the national debt is growing far faster than the economy. This is not sustainable – just ask the Greeks. For the moment, however, the financial world seems content to lend the US government almost unlimited quantities at microscopic interest rates. 2012 is an election year, so the conventional (and perhaps optimistic) wisdom is that, (1) hard choices about bringing our deficit under control will not be forced upon us in 2012 (by, say, a market crisis of confidence in US Treasury debt), and, (2) we will make the hard choices in 2013. We concur that no politically unpopular decisions will be voluntarily made in 2012. We are less confident that difficult decisions will be taken in the year following, absent external pressures, but one can always hope.

The Fed has stated its intention to maintain its easy monetary policy, i.e., very low interest rates, for the foreseeable future, and it's not hard to see why. Europe teeters on the brink of recession and possible financial crisis, the US recovery is anemic and precarious, and higher interest rates (leading to higher interest payments on the national debt) would blow a hole in an already massive budget deficit. The implications for savers (what we call investors) are sobering. When cash pays zero interest and even a 5-year government bond yields under 1%, expectations for returns on all asset classes must be calibrated downward. With long-term inflation forecast at about 2%, simply preserving purchasing power will take some work.

Corporate profit growth is a lone bright spot on the economic landscape. Profit margins are at historically high levels, the result of cost cutting, technology-based productivity gains, and the opening of new markets around the world. Profit gains have not, however, translated into higher capital expenditures or expanded hiring. Instead, companies are taking a cautious stance and sitting on large piles of cash. A higher level of confidence about the future will be required before the corporate world loosens its purse strings. If one is looking for a "wild card" on the upside, a return of business and consumer confidence might be the right target. Confidence is a fickle thing – hard to see coming, yet obvious after the fact.

Market Overview

The US stock market, for all its gyrations in 2011, ended almost exactly where it began the year. With the effect of reinvested dividends, the total return on the S&P 500 was just 2.1% for the year. This innocuous number doesn't tell the whole story – the index climbed 5.9% in Q1, ended flat in Q2, sheared off 13.9% in Q3, and then regained 11.8% in Q4. In our third-quarter review, we alluded to our perception that many of the pronounced short-term swings seen in 2011 were driven by news stories and developments with very little economic substance. It continues to be the case that investors with short time horizons seem to have a disproportionate effect on the daily moves of the stock market. This makes it more difficult for long-term investors to stick with their investment plan, but all the more important to do so. Our advice stands: do your best to tune out the noise.

Asian markets were hit hard in the first quarter of 2011 by the earthquake, tsunami, and nuclear disaster in Japan. Though the recovery is under way, disruptions in Japan's manufacturing sector continue to ripple through the global supply chain, and a lot of physical and human capital was damaged or lost. Rising inflation, particularly in food prices, affected China and southeast Asia during the year,

contributing to poor stock market performance. Pacific markets dropped 0.3% in the fourth quarter, finishing 2011 down 13.6%.

European stock markets tracked those in the US closely for the first half of the year, before coming completely untethered in late summer. While US markets dropped 13.9% in Q3 and then surged 11.8% in Q4 to finish the year up 2.1%, European markets plummeted 22.6% in Q3 and then gained back only 5.5% in Q4 to finish down 10.5% for the year.

The MSCI Emerging Markets index returned 4.5% in the fourth quarter, but finished 2011 down 18.2%. About one-third of this result can be attributed to the currencies of these nations depreciating against the US dollar, with the rest coming from downward moves in stock prices. Take a typical example of this “double whammy” effect: Brazil’s stock market, from the perspective of a Brazilian, lost 12% in 2011. But to an American investor who had to convert dollars to Brazilian reals at the beginning of the year, invest, then convert back to dollars at the end of the year, the total loss was almost 22%, thanks to the real’s depreciation relative to the dollar. Currency effects can swing both ways, and emerging market currencies are expected to significantly appreciate as these economies transition from “developing” to “developed” in the years to come, but short-term movements in currencies can have pronounced effects on investor returns.

Yields on 10-year US Treasuries held steady at about 2% during the fourth quarter, but are down significantly from 3.3%, where they began 2011. Bond yields and prices move inversely, so long-term Treasuries experienced massive price appreciation as a result of this yield compression. The total return (interest plus price increase) on long-term Treasuries was an astounding 29.9% in 2011, outperforming all other major asset classes. (To put this number in perspective, in order for the 30-year Treasury to again return near 30% in 2012, the interest rate on long-term Treasuries would need to drop from 2.9% at the end of 2011 to about 1.5% at the end of 2012. Impossible, no, but surely not something to expect or hope for.) A decrease in US Treasury yields was not at all an intuitive or obvious outcome for 2011, given the debt ceiling hostage situation, the US credit downgrade, and failed attempts at reigning in our federal deficit, and some prominent financial pundits bet (incorrectly) on an increase in our borrowing costs. In spite of all these factors, investors still think our bonds look better than those from Europe or elsewhere. PIMCO’s Bill Gross (who, incidentally, bet the wrong way on Treasuries last year) calls Treasuries “the cleanest shirt in the dirty laundry pile”.

Total Returns	Q4 2011	2011
CPI-U *	-0.1%	3.2%
STOCKS		
S&P 500	11.8%	2.1%
Financials	10.8%	-17.1%
Energy	18.2%	4.9%
Utilities	8.3%	19.9%
S&P MidCap 400	13.0%	-1.7%
S&P SmallCap 600	17.2%	1.0%
MSCI Europe	5.5%	-10.5%
MSCI Pacific	-0.3%	-13.6%
MSCI Emerging Markets	4.5%	-18.2%
BONDS		
Barclays US Aggregate	1.1%	7.9%
Barclays Short-Term Govt/Credit	0.4%	3.1%
Barclays Long-Term Govt/Credit	2.6%	22.5%
Barclays Municipal	2.1%	10.7%
Barclays Fixed-Rate Mortgage-Backed	0.9%	6.2%
Barclays Inflation-Protected	2.7%	13.6%
CSFB High-Yield	6.0%	5.5%
Citibank Non-Dollar World Government	-0.5%	5.2%
ALTERNATIVES		
MSCI REIT (Real Estate)	15.3%	8.7%
Gold Bullion	-2.8%	11.7%
DJ-UBS Commodity	0.4%	-13.3%
<i>Sources: Morningstar, Bureau of Labor Statistics, MSCI</i>		
<i>* Q4 reported as three-month change through 11/30/2011</i>		

In other bond news, municipal bonds returned 2.1% in Q4 and 10.7% for 2011, in spite of dire predictions in late 2010 that the market for munis was in for a meltdown. Tax revenue has stabilized as the odds of another recession have lessened, and municipal defaults were infrequent. Though the muni yield curve shifted downward slightly in the fourth quarter, the spread (or differential) between muni yields and Treasury yields has increased, making munis relatively more attractive.

2011 was a dramatic year for gold, with the metal's price rising 11.7% over the period – its eleventh consecutive annual rise. Despite a downward correction of about 2.8% in the fourth quarter, demand for gold remains healthy among those that view it as the only currency that can't be printed by a government. Gold remains the quintessential hard asset, despite its limited industrial uses and lack of a dividend or interest payment.

In currency markets, the dollar appreciated relative to major trading partners in Q4 and 2011 as a whole. The euro was hit particularly hard by the uncertainty surrounding the debt crisis, as well as the potential for a breakup of the euro currency union. Switzerland, which never adopted the euro, was forced to actively defend the Swiss franc from export-damaging appreciation. Much like the Swiss banking system, the Swiss currency has garnered a reputation as a safe place to park cash, well away from the debt crisis in Europe and fiscal trouble in the US. By using open-market operations to reduce the value of the franc, Switzerland hopes to protect chief exports like pharmaceuticals, machinery, and watches.

US Dollar versus	Canadian Dollar	Yen	Euro	Pound	Dollar Index
Q4 2011	-2.1%	-0.1%	3.7%	0.6%	0.3%
YTD 2011	1.6%	-5.7%	2.3%	-0.9%	1.5%

With another year behind us, we thank you for your business and for entrusting your assets to our management. Be sure to let us know if your financial circumstances or objectives have changed in any significant way. Please call or email whenever we may be of assistance.

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